Gina Harrison

PACIFIC TELESIS
Group Washington

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February 13, 1995

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

EX PARTE

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W. , Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: CC Docket No. 95-115, Subscriber Penetration; CC Docket No. 80-286, Universal Service

Yesterday, Colin Petheram and Raoul Arajo, Consumer Affairs Directors, Pacific Bell, Alan Ciamporcero, Vice President, Federal Regulatory Relations, Tim Tardiff, Vice President, National Economic Research Associates, and Jorge Schement, Professor of Communications and Information Policy, Penn State University and Rutgers University, and Dean of Research and Graduate Programs, Penn State University, and I met to discuss the issues summarized in the attached documents with the following persons:

Joseph Farrell, Chief Economist

From the Office of Plans and Policy:
Mark A. Corbitt, Director, Technology Policy

Alan Ciamporcero was not present at our meeting with the following persons:

From the Office of Commissioner Ness:
James L. Casserly, Senior Advisor

From the Accounting and Audits Division, Common Carrier Bureau:
Andy Mulitz
Pam Szymczak
Duffy Knoll
Jeanine Poltronieri

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From the Industry Analysis Division, Common Carrier Bureau:
Emily Hoffnar
Alex Belinfante
Larry Povich

We are submitting two copies of this notice in accordance with Section 1.1206(a)(1) of the Commission's rules. Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions.

Sincerely,

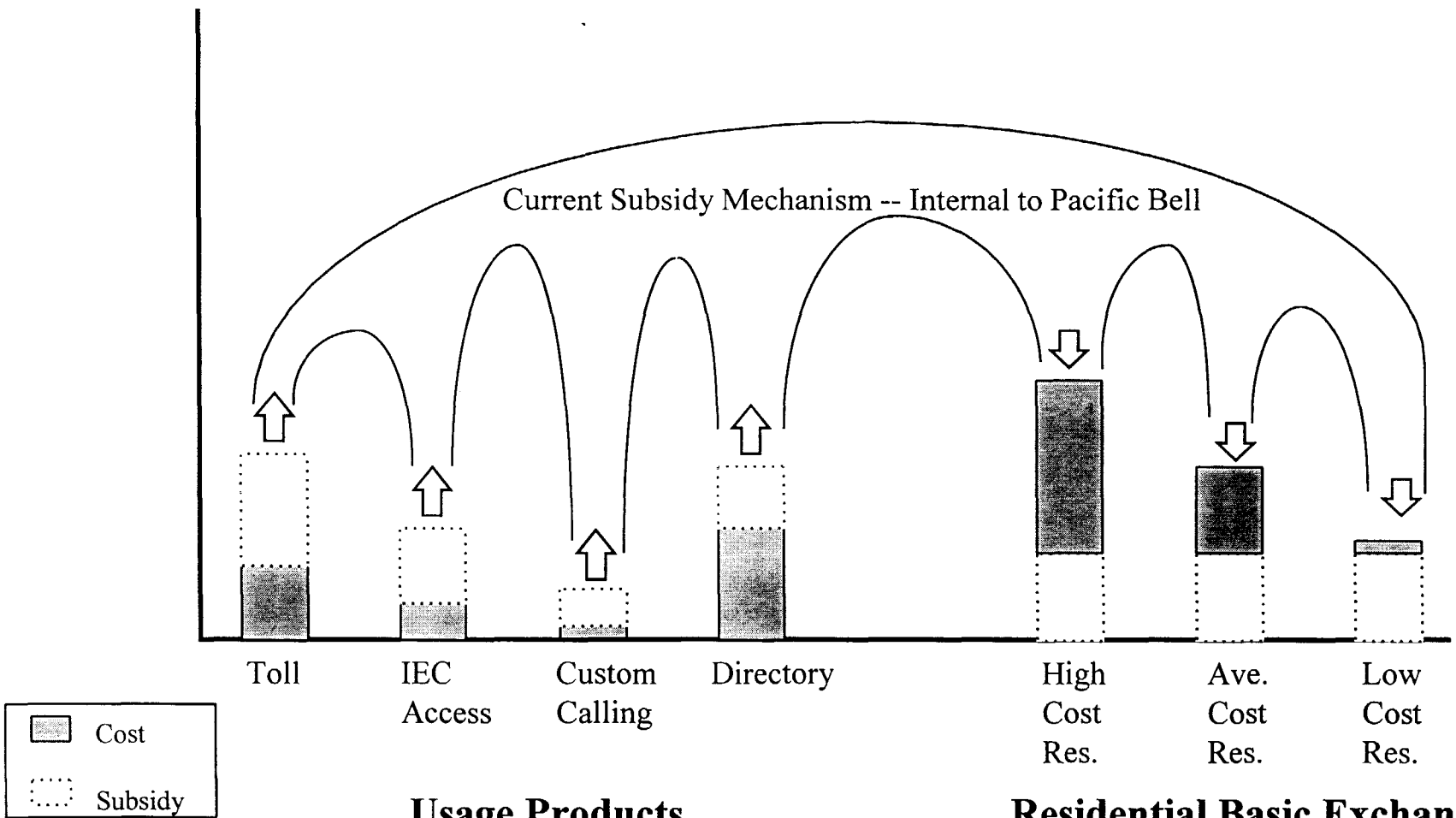
Gina Harrison

Attachments

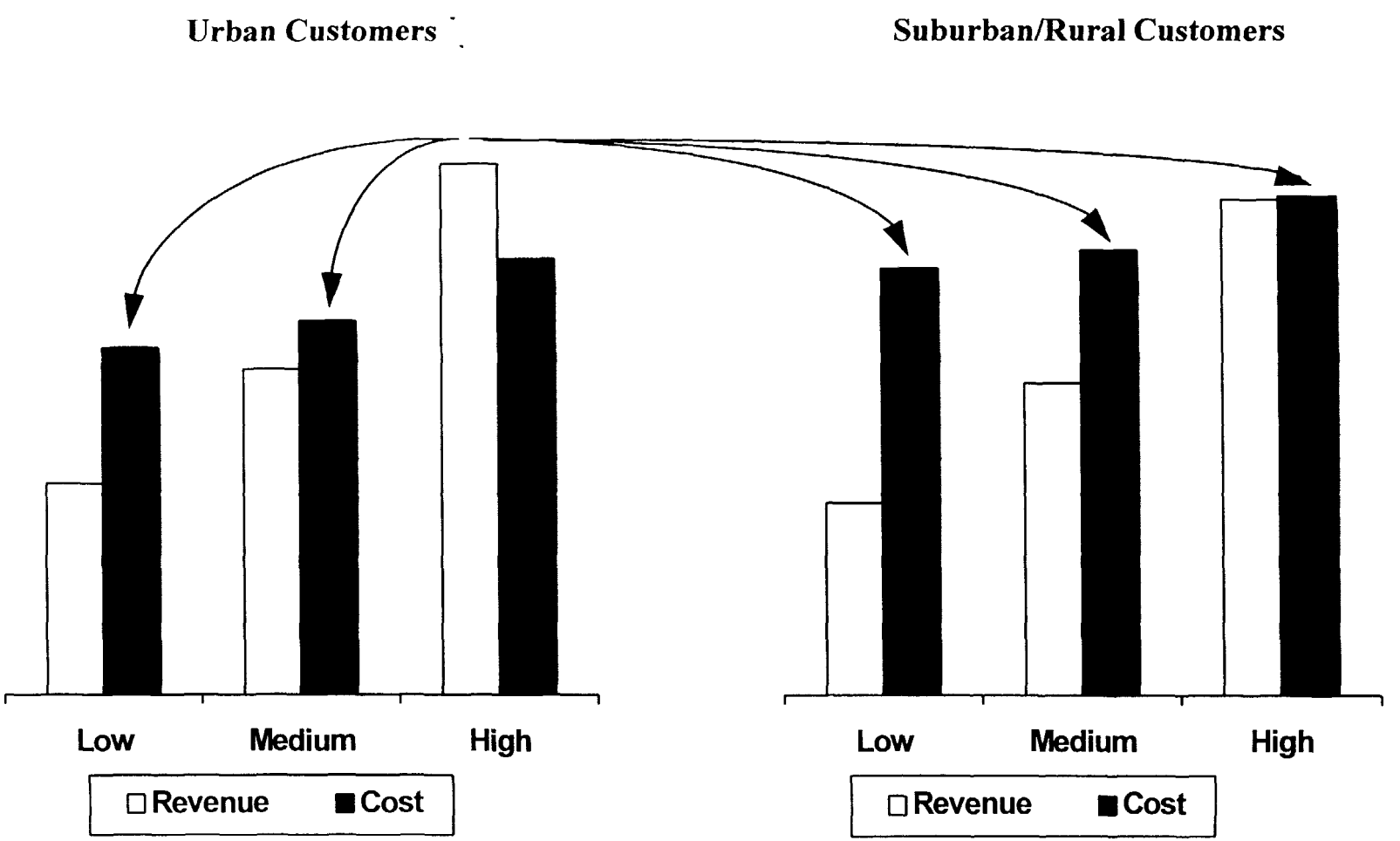
cc: Alex Belinfante
James L. Casserly
Mark A. Corbitt
Joseph Farrell
Emily Hoffnar
Duffy Knoll
Andy Mulitz
Jeanine Poltronieri
Larry Povich
Pam Szymczak

Universal Service

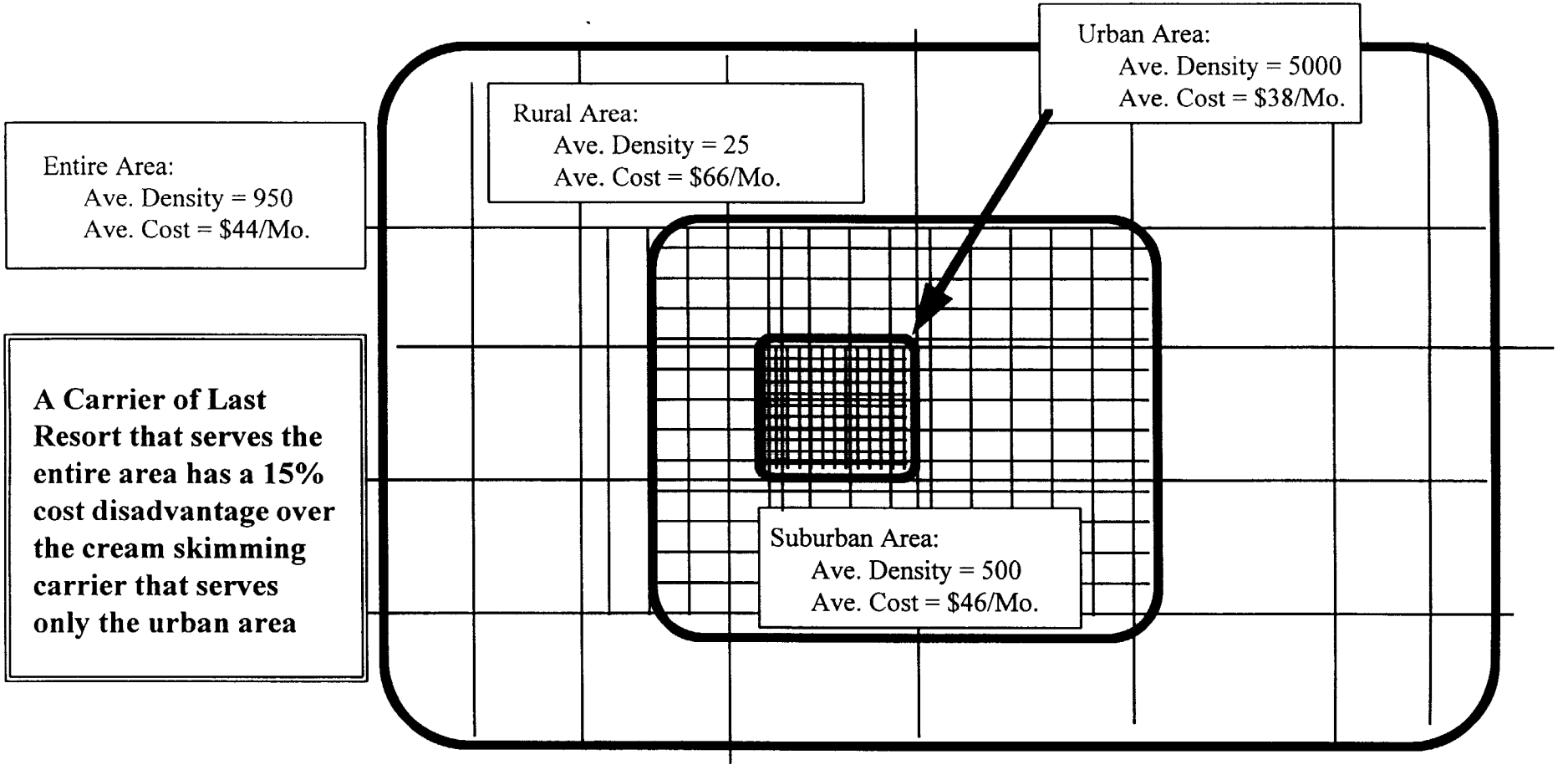
Universal Service is Maintained Today by Subsidies Internal to Pacific Bell (and Other LECs)

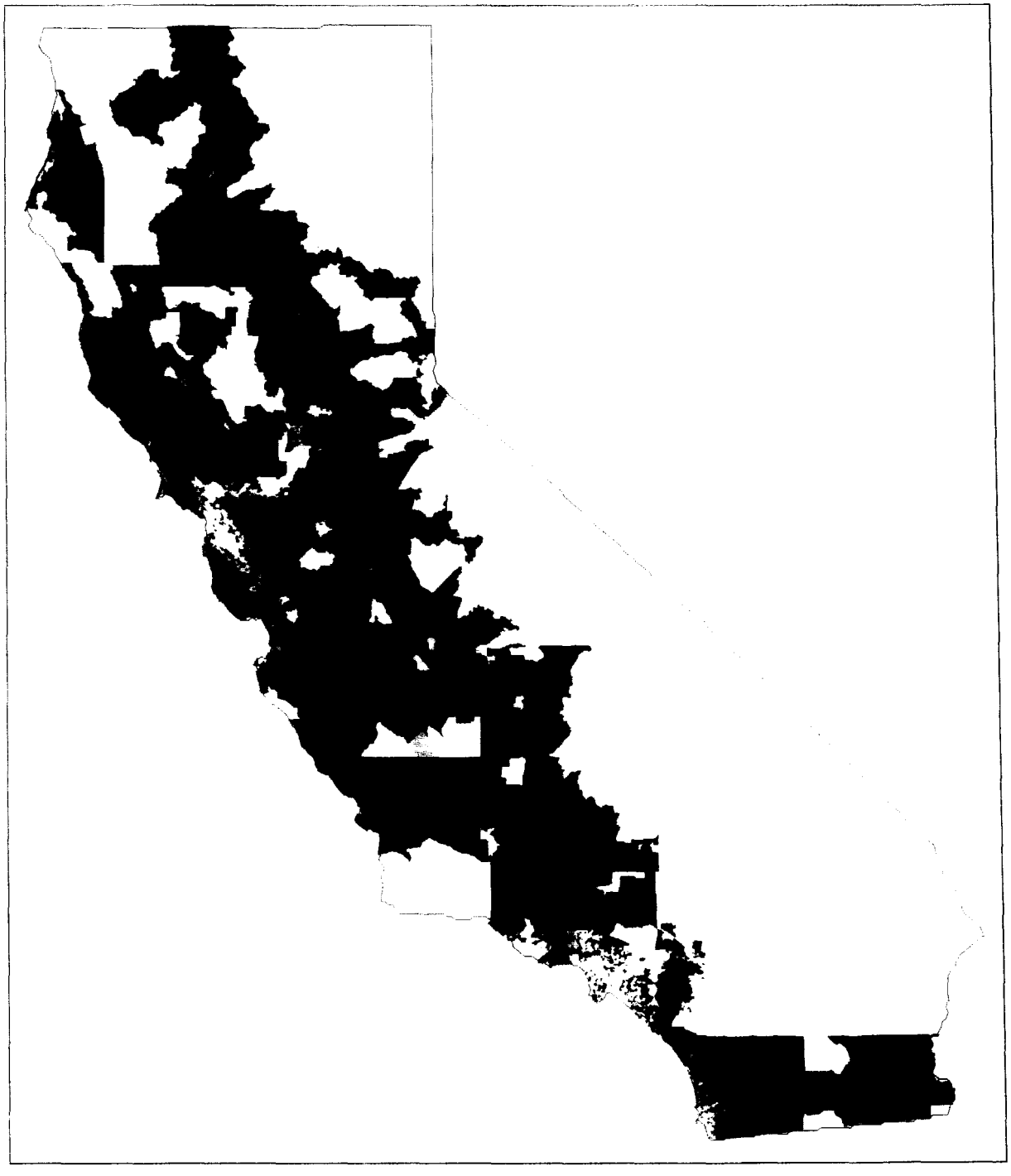


On a Residential Customer to Customer Basis, the Subsidy Flows From Urban to Suburban/Rural and High Use to Low Use

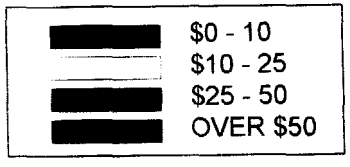


Subsidy Within the Exchange Area Can Occur Even Within a Rural Exchange





UNIVERSAL SUBSIDY AMOUNTS PER CENSUS BLOCK GROUP COST PROXY MODEL PACIFIC BELL AREA



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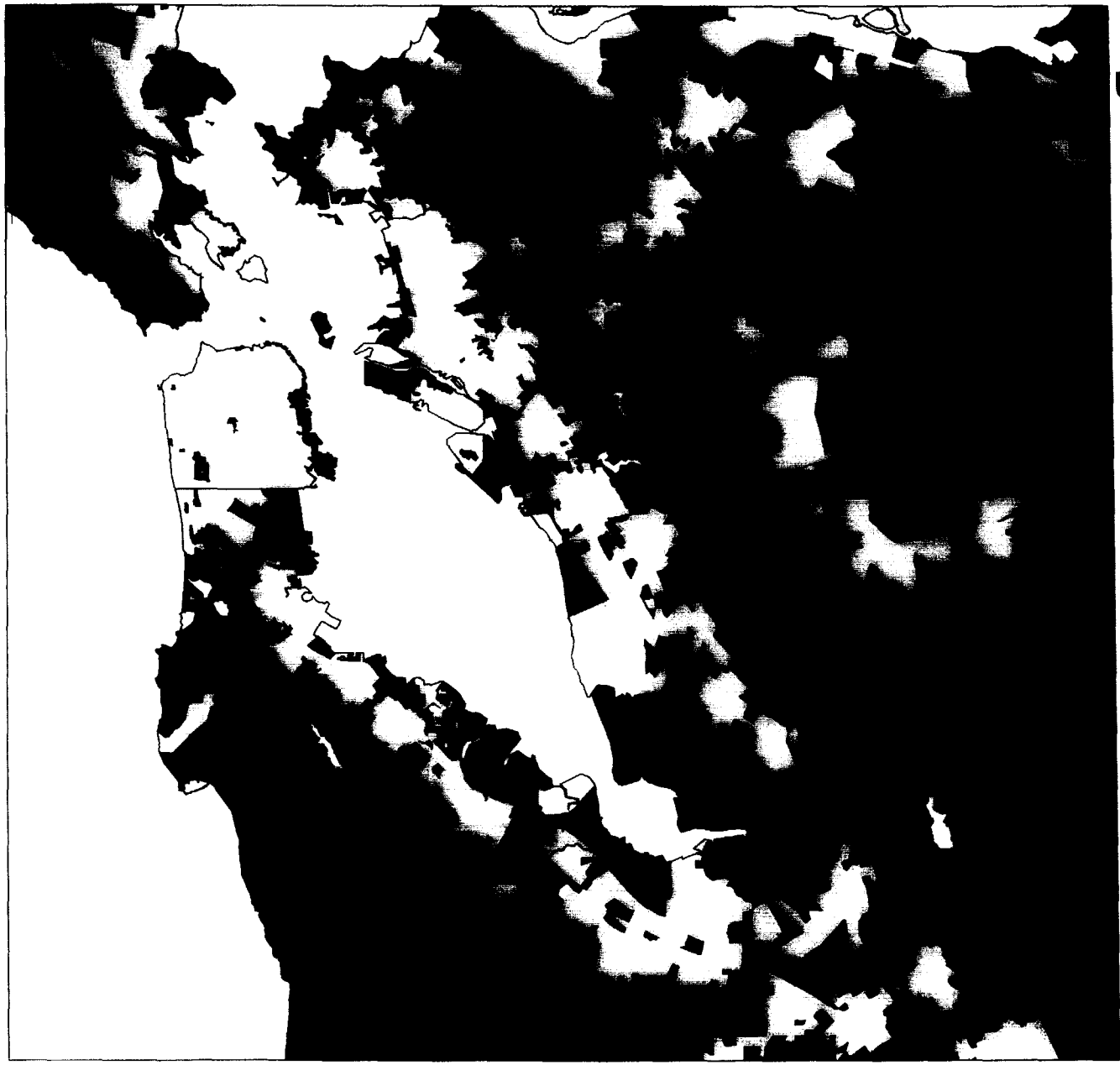

UNIVERSAL SUBSIDY AMOUNTS PER CENSUS BLOCK GROUP COST PROXY MODEL BAY AREA

$0 - 10
$10 - 25
$25 - 50
OVER $50
COUNTY BOUNDARIES

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ERSAL SUBSIDY AMOUNT
R CENSUS BLOCK GROUP
COST PROXY MODEL
LOS ANGELES AREA

$0 - 10
$10 - 25
$25 - 50
OVER $50

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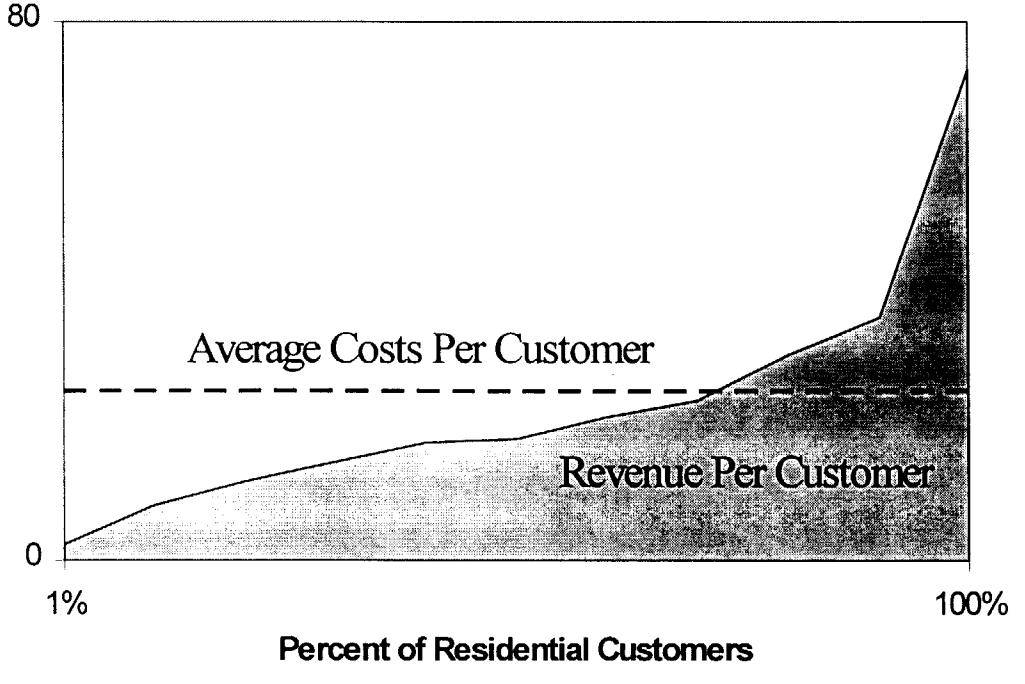
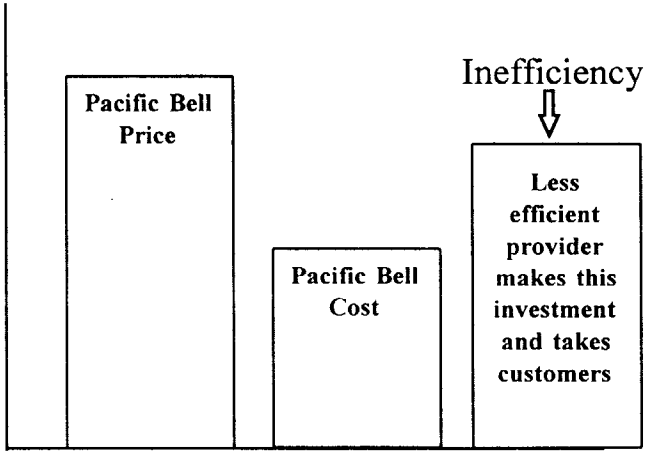
A Very Small Number of Residential Customers are Paying the Cost of a Very Large Body of Residential Customers

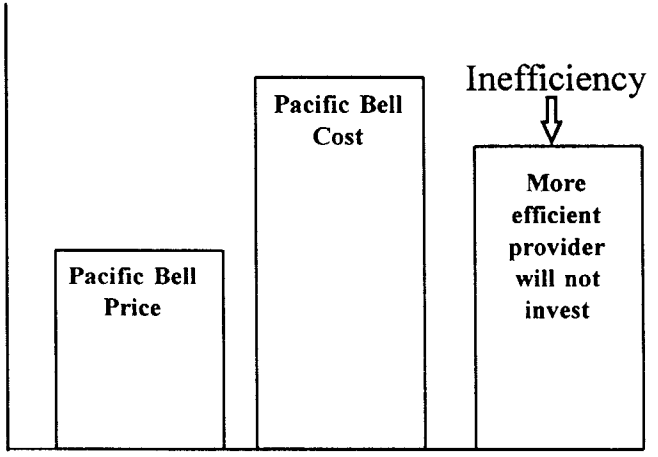
- This is a very serious cream-skimming opportunity. California has both extremes -- densely populated urban areas and the large expanses of a rural agricultural economy. Average rates of the incumbent provider will result in inefficiency in the marketplace.



The Economic Result is That a Less-Efficient Provider Could be Attracted to Invest While a More-Efficient Provider Could be Discouraged From Investing



Product A or Area A



Product B or Area B

The net result is that California encourages an inefficient deployment of investment. Already we see four providers of fiber networks overbuilding each other in dense metropolitan areas and no one clamoring to serve rural areas.

If Competition Continues Without Addressing the Subsidy Issues, Two Important Consequences Occur:

- No competition will develop where Pacific Bell prices are held artificially ***low***.
  - There will be little competition for suburban/rural customers, low use customers and high cost customers.
- Super-competition will develop where Pacific Bell prices are held artificially ***high***.
  - There will be extraordinary competition for toll and access, especially in dense areas.

The Subsidy Mechanism Worked Perfectly Well in a Closed System of a Single Monopoly Provider

- Important societal goals were achieved and economic distortions were minimized.
  - ***Important Social Goals***
    - Statewide averaged rates kept rural rates low.
    - Low residential basic exchange prices maximized penetration of telephone service.
  - ***Minimal Economic Distortion***
    - Large users could avoid subsidizing residential basic exchange services *only* by building private networks.

Public Policy Must Create New Pricing Structures and a Universal Service Subsidy Mechanism That Works in a Competitive Environment.

- Competition is a fact in the California access and toll markets.
- In 1996, California local service markets will be completely opened to competition: facilities based, resale and unbundled services.
- Unless inflexible and subsidy-laden pricing structures are reformed, competition will quickly eliminate current sources of subsidy.
- A Universal Service subsidy mechanism must be established to carry out public policy initiatives which can no longer be supported through cross-subsidization.

A Universal Service Fund is a Viable Alternative to Total Loss of the Subsidy

- An external mechanism, applicable to all providers, that preserves existing subsidy flows could be implemented.
  - The customers of all providers of ***subsidizing*** services would contribute to the subsidy fund.
  - The customers of all providers of ***subsidized*** services would receive the benefit of subsidy funding.

Universal Service Alternative Plan

- ***Universal Service Fund - Determining the Amount of Subsidy***
  - The size of the fund would initially be determined based on incumbent LEC costs.
  - A cost proxy model will be used to estimate the amount of subsidy by census block group or other geographic unit. The model will incorporate primary cost drivers such as population density, loop length, geological terrain characteristics (e.g., type and depth of bedrock) and technology mix.
  - The total amount of the fund shall be the difference between the revenue from residential basic exchange service as defined by policymakers and the proxy cost of such service plus a reasonable share of joint and common costs.

Universal Service Alternative Plan

- ***Universal Service Fund - Eligibility***
  - To be eligible to receive funds, the local exchange carrier agrees to be the carrier of last resort for residential and business subscribers within its serving area, using its own loop or loop-equivalent facilities.
  - The local exchange provider must offer residential basic service as defined by the Commission at a price set by the Commission.
- ***Universal Service Fund - Collection and Distribution Mechanism***
  - The sources of funding should be broadly-based and the mechanism for collecting and distributing funds should be competitively neutral.
  - Qualified local exchange carriers would receive the pre-determined level of funding for every high cost residential customer they serve.

Funding the Universal Service Subsidy

- Definition: Subsidy = Target Price - Affordable Rate
- Who gets subsidy: Customers of Qualifying LECs and CLECs in the form of a virtual voucher
- Who pays subsidy: Customers of telecommunications providers in the form of a surcharge on revenues (or "value-added" revenues)

Funding the Universal Service Subsidy

Average Subsidy per Line per month	$10
Lines (millions)	10
Annual Subsidy (billions)	$ 1.2
External Funding	
Revenue Base	$10
Surcharge	12%
Offsetting Reductions in	
IntraLATA toll	
State Access Charges	
Federal Access Charges	
Other above-cost services	

Adoption of a Universal Service Funding Mechanism Preserves Important Commission Goals in a Manner Consistent with Local Competition

- Economic benefits -- competitors would invest where they are more efficient than Pacific Bell rather than where they are protected by artificially high Pacific Bell prices.
  - ➔ *leading to efficient deployment of societal resources*
- Societal benefits -- averaged prices and subsidy to residential customers would be preserved in a competitive environment.
  - ➔ *consumers would not be encouraged to change providers in order to avoid the subsidy*

The FCC's Role in Universal Service

- FCC goals for universal service will facilitate the evolution of the current mechanism into the competitive environment.
  - maintain competitive neutrality of any funding mechanisms
  - provide incentives for efficient investment and operations
  - reduce barriers to competitive entry
- The use of proxy costs and smaller geographic areas will foster competitive neutrality, efficiency and the targeting of subsidy to truly high cost areas, regardless of who is providing the service.
- The FCC's current Universal Service NPRM is limited in scope and does not address many issues in the comprehensive way needed.
- The FCC has an opportunity to focus its efforts on the broader issues raised by the Telecommunications Act and its current proceedings on access reform.

CPUC Proposed Universal Service Rules

- Develops a universal service funding mechanism that targets high cost areas throughout the state.
- Replaces the existing California High Cost Fund with a virtual voucher system of funding. Requests comment on the use of the net trans account system or an all end-user surcharge for the collection and distribution of funds.
- Proposes an auction mechanism be used in the event that no carrier is willing to undertake the carrier of last resort obligation within any given area.
- Requests comments on whether rates in high cost areas should be raised to either the lower of cost to serve or 150% of the weighted average rate in low cost areas.
- Provides a definition of the elements of basic service and stipulates that all local exchange carriers must provide these elements to all customers in their service area if they want to avail themselves of subsidies.
- Proposes that costs for all the geographic subsidy areas be developed by way of proxies.
- Allows for resale-based competition prior to the establishment of an operational universal service funding mechanism.

1995 Telecommunications Act
Universal Service Timeline

- Establishes a FCC/State Joint Board within one month of enactment to recommend actions to preserve and advance Universal Service.
- Joint Board shall make initial recommendations within nine months of its establishment.
- Universal Service proceeding must be completed by the Commission within 15 months of enactment, including definition of Universal Service components and establishment of an implementation timetable.
- Proceedings to implement subsequent Joint Board recommendations must be completed within one year.

Six Myths of Telephone Penetration: Universal Service from the Bottom Up

RUTGERS UNIVERSITY PROJECT ON INFORMATION POLICY

Dr. Milton Mueller
Project Director and Principal Investigator

Dr. Jorge Reina Schement
Principal Investigator

Rutgers University School of Communication, Information and Library Studies
New Brunswick, New Jersey 08903 Fax 908-932-1202.

This paper looks at universal service from the bottom up. Its purpose is to contest the myths that have grown up around telephone penetration and the social condition of phonelessness. The summary we present here is drawn from a report titled, *Universal Service from the Bottom Up: A Profile of Telecommunications Access in Camden, New Jersey* , to be published in January 1995.

The study was funded by Bell Atlantic, and draws upon extended interviews with families which do not have telephone service now, or have fallen off the network in the recent past. The interviews were conducted in Camden, New Jersey as part of the ongoing research of the Project on Information Policy. In addition, the study also reviews and interprets statistical data, concerning the socioeconomic factors affecting telephone penetration nationwide, collected by the Decennial Census, the Current Population Surveys, and proprietary sources supplied by Bell Atlantic.

With a telephone penetration level of 80.6%, Camden falls significantly below the national average (94%). Camden's racial and ethnic composition and income levels match those of many other low-penetration areas in the United States. Thus, lessons learned in Camden offer insights into nationwide conditions of phonelessness.

The study addresses three questions:

1. Who are the phoneless?
2. What are the economic or social factors that lead to or maintain their disconnection from the PSTN?
3. Once we know the answers to questions #1 and #2, how should universal service policy be reformulated?

Key Findings:
The implications of our research challenge conventional wisdom about universal service.

MYTH #1: The affordability of telephone service hinges on the price of local access. Thus, the price of basic monthly service rates should be the focus of universal service policy.

FACT: Most marginal users are driven off the network by *usage*-related costs, such as long distance tolls, collect calls, credit card calls, and optional features, rather than access-related costs. In addition, for new users with low incomes, the chief economic barrier is the initial deposit (at least $100) required by telephone companies to protect themselves against the buildup of uncollectable, usage - related bills.

In the new information infrastructure, telecommunications access is the equivalent of a nearly unlimited line of credit. As the features and capabilities of the public network expand, the risk that marginal users will consume more services than they can pay for increases. The key issue in universal service policy is how to maximize access for users while minimizing credit risk for service providers. This problem is complicated by the new role of local exchange carriers as billing and collection agents for long-distance companies.

Myth #2: Universal service subsidies should be focused on the elderly. Older Americans are most in need of telephone access and of subsidies.

Fact: As a group, older Americans have the highest telephone penetration rates of all. At 98%, the penetration rate for Americans 65 years and older exceeds the national average by four percent. Even when their income is very low, penetration rates for older people exceeds that of younger people in corresponding income groups. The real penetration problem lies with younger age groups, especially when they are members of racial or ethnic minorities. Nationwide, penetration for households headed